DOW THEORY LETTERS INC.

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THE MARKET: Some of the implications of the big picture (i.e. the primary bear market) are beginning to appear in the economy. Our politicians in Washington are becoming quite concerned about inflation, even while selective deflationary forces are making their appearance on the world scene. For instance, the London Economist's indices of "All Items" and "Metals" are now breaking down viciously, while its other two indexes, "Food" and "fibers" are in the process of turning down. In an effort to stem the tide of domestic inflation (while simultaneously increasing Government tax receipts), President Johnson has asked for suspension of the 7% investment tax until 1968 as well as a suspension of laws permitting an accelerated depreciation program.

Perhaps even more interesting is the Treasury's recent announcement that it will halt the sale of all U.S. Agency securities in coming months. This procedure is supposed to ease interest rates by removing Federal Agency competition (for funds) from the money markets. The Treasury has also cancelled the sale of $800 million in Federal National Mortgage Association "Participation Certificates" which were scheduled for this year (sale of these Certificates was a bookkeeping device calculated to hold down the budget). Instead, Social Security and other Federal Trust Funds will be asked to supply needed money, and these funds will be augmented by public sale of Treasury debt instrutments (i.e., bills, notes and bonds). In response to this, yields on the 91-day Treasury bills last week rose to an incredible all-time high of 5.4%.

It all boils down to this: the money supply will be increased again via the "printing presses." When that occurs, we can be sure of one thing, the Federal Reserve ratio (i.e., the ratio of Federal Reserve Notes to Gold Certificates) which is now below 33%, will accelerate its decline. It has been estimated that at current rates this ratio will drop to the 25% legal limit around next July. However, if the money supply is to be expanded again, and if the gold outflow continues, the ratio will probably touch the 25% legal limit during Spring of 1967. Furthermore, a whopping budget deficit is sure to result from the newly announced financing policies, and this will not sit well with the U.S.'s foreign creditors, many of whom are now getting "that old, uncomfortable feeling." It's a case of in one pocket and out of the other, and the Government's efforts to hold down interest rates while playing "now you see it, now you don't" with business will merely extend and ultimately intensify the bear market.

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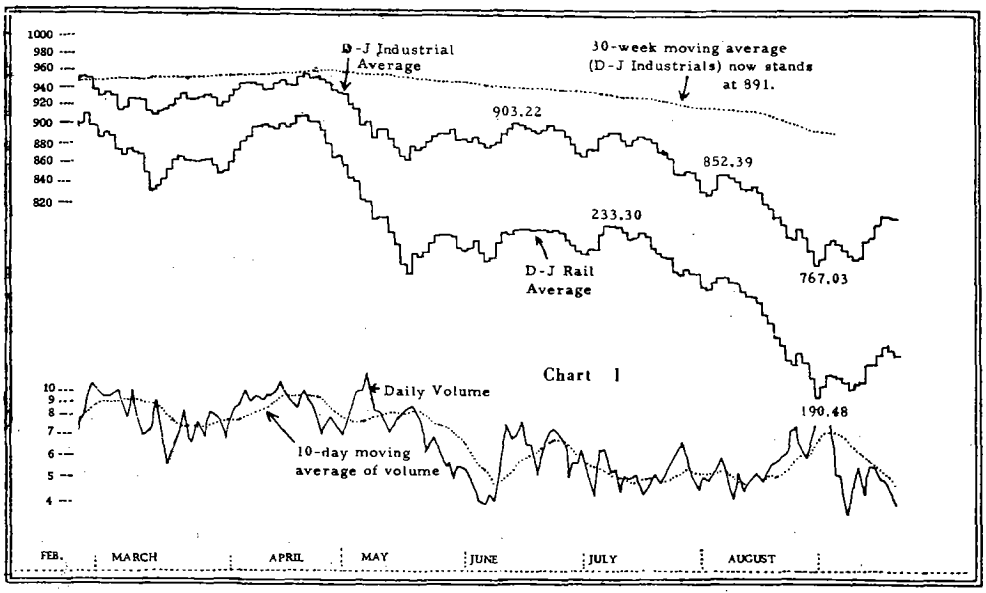
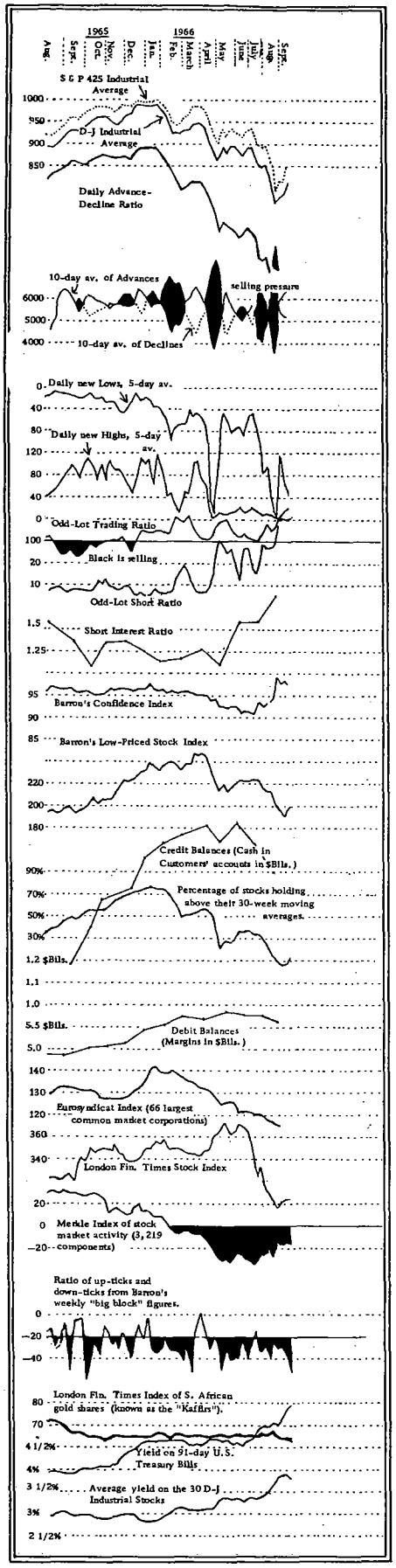


Chart I


1965
1966
S & P 425 Industrial Average
D-J Industrial Average
Daily Advance-Decline Ratio
10-day av. of Advances
selling pressure
10-day av. of Declines
Daily new Lows, 5-day av.
Daily new Highs, 5-day av.
Odd-Lot Trading Ratio
Black is selling
Odd-Lot Short Ratio
Short Interest Ratio
Barron's Confidence Index
Barron's Low-Priced Stock Index
Credit Balances (Cash in Customers' accounts in $Bils.)
Percentage of stocks holding above their 30-week moving averages.
Debit Balances (Margins in $Bils.)
Eurosyndicat Index (66 largest common market corporations)
London Fin. Times Stock Index
Merkle Index of stock market activity (3,219 components)
Ratio of up-ticks and down-ticks from Barron's weekly "big block" figures.
London Fin. Times Index of S. African gold shares (known as the "Kaffirs").
Yield on 91-day U.S. Treasury Bills
Average yield on the 30 D-J Industrial Stocks

Meanwhile, back on Wall Street the bear market continues to behave like a bear market, and a particularly deceptive one at that. Every time the declining Averages slice off enough points to place the financial community on the edge of panic, the market hesitates, then rallies. Each rally is greeted by the public as the beginning of the "next bull market" (at least, if we judge by the odd-lot transactions). Thus a pattern of major downward zig-zags continues to be traced by the bear market, with each important rally peak falling short of the preceding rally high and each primary bear leg breaking below the previous primary lows. Yet even this simple but fundamental picture seems to escape the majority of investors and traders. They are much too taken up with the minor or daily picture, and each successive day of rally (regardless of the severity of the decline which preceded that rally) is taken as another "sign" that the basic picture has changed. Would that it had!

I made mention above of the (typical) pattern of major downward zig-zags in this bear market, and although this may seem an absurdly simple thesis, it offers interesting implications under the Dow Theory. Obviously, if a bear market consists of a series of primary (downward) legs separated by (upward) corrections, anything which upsets the pattern is worth examining.

NOTES & QUOTES: I have just finished a book entitled "Yankee Genius" by Earl L. Smith. It is the biography of Roger Babson, founder of Babson Reports and the first owner of an advisory and investment counseling service in this country. At one time or another, Babson has owned or been connected with almost every major advisory service from United Business Service to Standard & Poor's. Babson is a shrewd New England businessman and an acute observer. His formula for success in investing can be summed up in a single word, PATIENCE.

I was fascinated by Babson's observations of the great English banking families, and I think the following will interest all subscribers. "The chief asset which a visitor to their (i.e., the banking families') offices saw were the oil paintings of their ancestors. These bankers may have had a ticker, but no private wire system and only two or three clerks. After becoming acquainted with these bankers.....Mr. Babson ventured to ask: "How, with these dingy offices, did your family build up an investment business which has made you all such very rich men?

"The reply was: 'It is because our family never had any overhead expenses and could always afford the patience to wait, years if necessary, before buying or selling. This enabled us, and now enables some of our clients, to make millions. We refuse to let anyone beat us in waiting! We always patiently watch the tides flow in and out and never attempt to fight their rise and fall. Yet our policy has made every boom less dangerous and every panic less severe.

"They then explained how they entered the market only once about every six (more or less) years, to buy securities when prices were low. These securities would then be kept for a few years until there was a boom, when younger and less experienced brokers were buying: then these old families would sell. The cash received they would 'loan out on call' for several years, if necessary, until another crash came, when they would again enter the market to buy. By this custom they not only made millions for themselves, but developed the great British financial system. Their program was based on Newton's Law of Action and Reaction.

"This slow but all-powerful system of investing built those great estates throughout England which then were the show places of the world. Strange as it may seem, these families, with their humble offices in London, owned palatial homes and thousands of beautiful acres in the country. Today, many of these great estates are deserted. This has partly been due to the families' failure to continue the financial policies of their ancestors. Too many younger generations speculated and lost all through impatience and greed. There is a lesson here to the investors in the U.S. who are tempted to speculate in order to offset high income taxes and high living costs."

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There has been much talk about silver consumption and vanishing supply but little of gold. Here are some facts. The U.S. gold reserve has dropped from $24 billion in 1949 to 13.2 billion today. Domestic gold production has dropped from 4.8 million ounces in 1940 to 1.4 million in 1964 (1964 was the year of the last authoritative count). At the same time gold consumption by industry has increased from 1.05 million ounces in 1940 to 4.8 million ounces in 1964. In other words, industry alone now consumes three times as much gold as produced in this country annually.

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From economist Melchior Palyi's column..."Far more significant are the measures which are supposed to cure the domestic cost-price inflation, inflation being the hard core of Britain's troubles. Freezing wages and prices is the chief weapon, supported by substantially higher taxes, slightly reduced government expenditures, and some degree of credit restraints.

"It is apparent at once that the burden of Britain's 'disinflation' is on the public and on business. The government--the burocrats and the politicians-- are scarecely affected. In fact, while all pay agreements, which have not come as yet in force, have to be canceled, Wilson himself, and his cabinet, and the members of parliament will get their raise. In any case, the private sector of the British economy is to be drained: the public sector remains affluent and gains in relative financial weight.

"Unfortunately, there are signs indicating that official minds work in a very similar fashion along the Potomic and Thames rivers. It may not be idle exercise to take a look at the Wilsonian policies in view of the potential appeal to Johnsonian minds."

In 1932 Robert Rhea, the great Dow Theorist, wrote: "When declines in a primary bull market result in violating the lowest points encountered during the last major secondary reaction of that market, it may generally be assumed that the primary trend has changed from bullish to bearish; the converse, of course, is usually a dependable means of determining when a bear primary movement has changed to the beginning of a bull market."

While no observation or "rule" about Wall Street is infallible, it would be of great significance if the Averages at any time during this bear market mustered enough strength to better preceding secondary highs (i.e., if the Averages could move above the peaks of the last upward secondary correction). The last secondary peaks were established during June-July at 903.22 (Industrials) and 233.30 (Rails). I doubt seriously whether this rally is going to carry over those points, but if it does I will review the whole situation with as much insight as I can offer my readers. Actually, as seen on Chart 1, the first little rally in August ended on August 5 at 852.39. I would be surprised if the current rally bettered that point, let alone the secondary high of 903.22.

The character of the latest rally has been violent and furious, and its form has been that of a "straight-up move" which is so typical of a rally in a bear market. For instance, considering that the bear market erased 228 points from the Industrial Average during a six-month period (February to August), it is interesting to note that in a period of 13 days (starting from the August 29 bottom) the latest bear market rally recovered almost one-quarter of those losses. This is in line with my statement in the Barron's article of September 5: "Reactions (whether in bull or bear markets) nearly always consume more time and more violent than the movements in the direction of the primary trend. It is not unusual, in fact, for a three-week rally in a bear market to retrace 30% to 60% of a

downward swing which may have taken many months to complete."

In Letter 330 I drew attention to the 50% Principle. I wrote: "The next potential move could be a testing of the halfway level of the entire 1962 (535.76) to 1966 (995.15) advance, a total rise of 459.40 points. The halfway level of the 1962 to 1966 advance is 765.46. If, on any forthcoming decline, the Dow breaks below the 765.46 level, the 50% Principle will be saying that there is a good chance that the Dow will ultimately probe the 1962 low area around 535.76."

Here is a case where even doubters must conclude that some higher force rules the market. On August 29 the Dow established a low closing of 767.03, less than two points from the halfway level. The current rally started from just a tiny fraction above the 50% mark. Conclusion: The 50% Principle remains bullish. A persistent refusal by the Dow to close below 765.46 would imply that in due time the Dow will test the area around the February, 1966 high. Conversely, a penetration of 765.46 would imply that ultimately the Dow will test the 1962 low area around 535.76. Because this is a primary bear market, the odds suggest that the halfway level (765.46) will break sometime in the foreseeable future.

OPINION: This writer reads everything from political pamphlets on the Left to economics on the Right. Many months ago I read an article in I.F. Stone's far-left weekly report entitled, "Can The U.S. Be Contained?" It seemed so absurd that I laughed at the time. But now I realize that to many people this is no longer a laughing matter. Least liable to laugh are the Europeans. As the Vietnam war expands, as the massive U.S. stock market (massive compared to the tiny European bourses) cracks, as the U.S. gold supply dwindles, as U.S. firms sop up whatever liquidity is left overseas, the thought of whether the U.S. can be contained must take on the threat of reality to many Europeans. It's not a joke anymore.

Since the 1930's the U.S. has been, as far as Europeans are concerned, a repository of strength, principles, responsibility and safety. Now doubts are rising, and they are rising fast. A few weeks ago U.S. News & World Report noted that many Europeans are now calling the U.S. "the sick man of the world." It's a cause for real concern, and as many serious students watch once-mighty Britain slip into the miasma of socialism and ineffectiveness, they wonder if the U.S. is not about to follow Britain's lead.

As a result of the U.S.'s major miscalculations in the Vietnam war, as a result of President Johnson's growing problems with Congress and as a result of the new bear market, many Europeans are becoming disenchanted with the U.S. as a repository for their capital. There is an excellent chance, in fact, that foreign money is, and will continue to, leave our markets for safer shores. According to economist Eliot Janeway, the sheer amount of foreign capital which is now a part of the U.S. structure, but which could leave if disillusioned, is much greater than anyone realizes. If this seasoned capital loses faith in the U.S., the pressure on all markets here could become enormous.

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DeGaulle, who only a few years ago was scorned and denigrated by the U.S., is now taken very seriously in all quarters. What is he doing? Why is he helping himself to U.S. gold? Why is he speaking around the world, directly attacking the U.S., telling us to get out of Vietnam, asking us to follow his example in Algeria?

The answer is that DeGaulle was the first statesman who recognized the U.S. as the world's only "Superpower." DeGaulle is a believer in the old "balance-of-power" system. When one nation becomes too powerful, when one nation overbalances all other nations, then that nation must be counter-balanced or tragic events may result. DeGaulle sees the U.S. as a superpower on the verge of running wild. Power seeks to justify itself and protect itself. In his eyes, DeGaulle sees the U.S. as a major danger to world peace. He believes that the U.S., in order to protect its political and economic interests, is capable of starting World War III. The only hope, as DeGaulle sees it, is to cut the U.S. down to size. How does one do that?

First, DeGaulle understands the historical power of gold. DeGaulle notes Britain, a nation with reserves, in the position of cow-towing to its conservative creditors despite the fact that its government is run by socialists. DeGaulle knows that grandiose socialist schemes have, in the past, always led to national bankruptcy. And history is repeating itself in the U.S. So DeGaulle, in an effort to reverse the tide of U.S. power, attacks it at its soft underbelly, its gold hoard. Secondly, DeGaulle seeks to build up a buffer force against the U.S. That buffer force is to include most of Europe and Russia. The third World force is to be China, the looming giant of the East. In time, thinks DeGaulle, the buffer force will be "cemented" and grow powerful, in time China will be a superpower to be reckoned with, and in time DeGaulle's new balance-of-power will be perfected. Of course, DeGaulle also sees France as rising to its splendor of old. France is to be the leader of Europe, linked with Russia and influential in Asia. Meanwhile, he sees the U.S. losing power (and gold), losing influence in Asia, sapping its strength in Vietnam, and on the verge of serious economic trouble.

If all this comes to pass, believes DeGaulle, then the world will be a safer place, the U.S. will be shocked back to reality, the buffer power of Europe and Russia will be a force to be reckoned with by both the U.S. and China, and sanity will once again have a chance to reign. It may or may not work, but it is a carefully laid-out plan based on reality. The U.S. opines DeGaulle, is like an ocean liner without a rudder, and it will lose to the tugboat with a plan.

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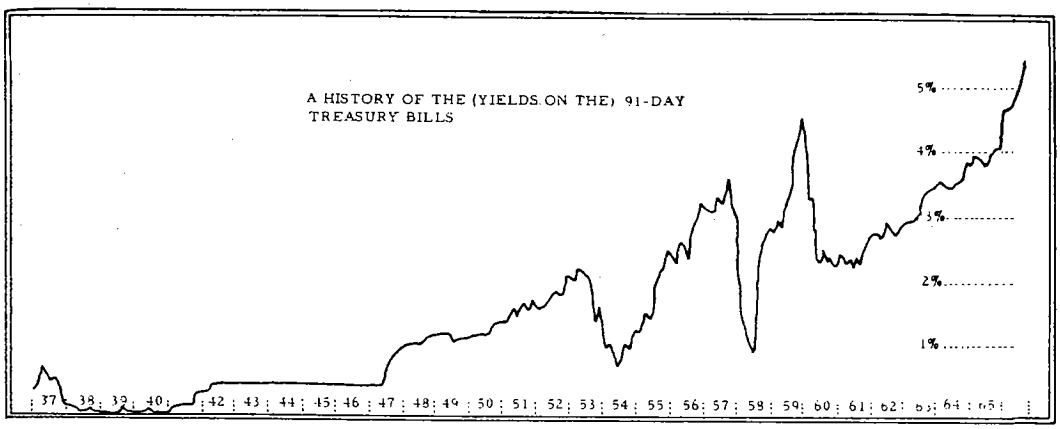
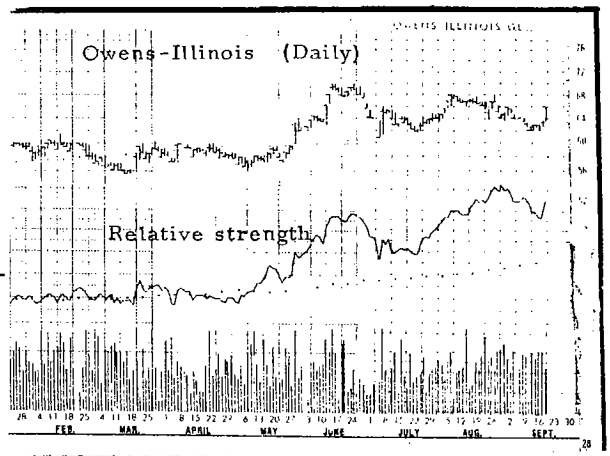
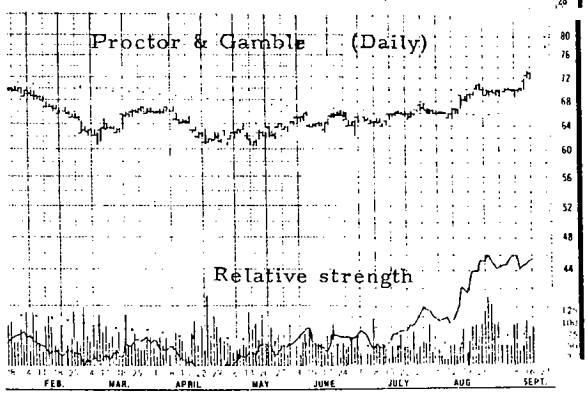
Meanwhile South Africa has presented another problem. Rich, scorned, she must also plan if she is to survive in a hostile world. Hated by the two-thirds of the world which is not white, denounced by the U.S. and Britain, South Africa has two mighty aces-in-the-hole. First, she is conservative and wealthy. Second, she produces 73% of the world's gold. South Africa has recently come forth with a deflationary budget, taxes have been raised, and gold is being withheld from the London Gold Pool. In the writer's opinion, South Africa is following DeGaulle's lead on gold. South Africa is about to use gold as an instrument of world power, and it will be most interesting to see where this policy may lead. One thing is sure. Even if the U.S. and Britain do not understand the power of gold as an instrument of power politics, the Communists do. Russia and China are fully aware of the power of the yellow metal, and both are making every effort to bolster their holdings. The scene is set for drama over Africa. But in this writer's opinion, history will favor those who understand the old adage, "Gold will win."

CHART OF THE WEEK: Pictured at right is the bellwether chart of U.S. interest rates, the yields on the 91-day U.S. Treasury bills. The big question now is, "Has the recent rally in the bond market signalled the top for interest rates?" The answer will only be known in retrospect. What we do know is that the U.S. is now financing the current war at rates far above anything seen in any other war (check the chart). Furthermore, the Treasury is now desirous of raising new money in the bill, note and bond market. In response, the bill rate "has gone through the roof." Time will tell whether the money market has seen its ceiling in interest rates. So far, all we have is a rally in bond prices, with bills actually hitting new highs in yields. This writer is not yet ready to go on record as saying the worst of the money and yield squeeze is behind us. The chart has not said so either.



STOCKS: I want to illustrate why I believe it is so hard to beat the primary trend during a bear market rally. The two strongest-looking Dow stocks (see Letter 333) on the decline were Owens-Illinois and Proctor and Gamble. Assuming one had purchased both of these issues at the August 29 low, one would have paid around 69 for Proctor and about 65 for Owens. Following the rally to the August 16 high, one would have had about a 5 point profit in Proctor and one would have been even on Owens. Total pointage gained on this scalping operation would equal 5 points. Allow 2 point for in-and-out commissions on these two 100-share lots and one would be sitting at the recent rally high with a 3 point total profit. Hardly enough to justify the sweat of buying into a bear market rally that would turn down at any time and leave the scalper with losses.





Actually, it was many of the stocks which have taken the worst drubbing such as GM, Anaconda and Standard of Jersey which made up most of the points on this rally. On the next rally it may be different. Furthermore, many of the glamor issues have not fared well on the recent rally, and stocks such as Admiral, Motorola and Zenith behaved rather sluggishly during the advance. Normal expectations would have been for a sharp recovery in the stocks which had recently been so popular. Moral: It's difficult to take points out of a bear market rally. It usually requires a long period of bull market advance to produce gains in a representative list of good issues. Bear market rallies cannot be counted upon to lift the general list. And bear market rallies can be short, very short indeed.

LATE NOTES: The news clip (at right) from the Sept. 20th morning paper needs no explanation. Who said it can't happen here? .... Meanwhile, the market drifts off on low volume. But remember, volume can be very deceptive in a primary bear market. ... Humphrey Neill (of "Contrary Opinion" fame) writes in his latest report that he is disturbed by the complacency with which the public greets this decline. He wonders if all the optimism isn't misplaced. ... Charts of Proctor and Owens-Illinois (above) courtesy of Traders Research, 1431 Pearl St., Alton, Illinois 62003.

T-Bill Rate Hits 6%

Compiled from The San Diego Union News Services

The government's short-term borrowing costs cracked through 6 per cent for the first time ever with yesterday's weekly offering of Treasury bills.

The record yields for both 91-day and 182-day issues reflected the increasingly tight money market. It was the 182-day issue that produced a yield of more than 6 per cent — specifically, 6.039.